

CC:IT&A:03
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Subject: [REDACTED] and Subsidiaries
Erroneous Refund

This is in response to your memorandum of October 10, 1990, concerning an erroneous refund made to the taxpayer in [REDACTED]. You requested advice concerning whether the refund could be recovered.

Facts

In [REDACTED], the Service mailed the taxpayer a notice of deficiency for calendar years [REDACTED] and [REDACTED]. The taxpayer paid the tax and interest due and the Service assessed the following amounts (all amounts have been rounded to the nearest dollar) on the dates shown:

Tax	\$ [REDACTED]	\$ [REDACTED]
Interest	[REDACTED]	[REDACTED]

The taxpayer then filed a claim for refund for both years. Following disallowance of the claim, the taxpayer filed suit for refund in the Claims Court. The taxpayer lost the initial trial but won on appeal. The government did not petition for certiorari. The parties agreed that the tax was overpaid in the following amounts:

[REDACTED]:	\$ [REDACTED]
[REDACTED]:	\$ [REDACTED]

The Claims Court thereupon entered a judgement against the United States for \$ [REDACTED] for [REDACTED] and \$ [REDACTED] for [REDACTED]. The amounts represent the agreed-upon overpayments of tax plus the interest paid on the deficiencies in [REDACTED].

On [REDACTED], the Service Center issued refunds of \$ [REDACTED] for [REDACTED] and \$ [REDACTED] for [REDACTED]. On [REDACTED], an additional refund of \$ [REDACTED] was issued for [REDACTED]. The Service Center computed interest due taxpayer of \$ [REDACTED] for [REDACTED] and \$ [REDACTED] for [REDACTED]. According to an [REDACTED] (informant), the taxpayer knew that the refund for

08694

█████ was excessive but that the original refund for █████ was insufficient. The taxpayer decided to keep the refund and initiated a telephone call to the Service to secure the additional refund for █████.

In retrospect, it appears as if the Service posted the \$█████ for █████ and the \$█████ for █████ as reductions of the original tax liability rather than as abatements of the █████ assessments and the interest paid by the taxpayer. Thus, the interest paid to the taxpayer in █████ included interest computed retroactively to the due dates of the return rather than to the dates of payment of the deficiency and interest in █████.

Meanwhile, the taxpayer had filed for and received tentative refunds under section 6411 of the Code for carrybacks of losses and credits for █████, █████, and █████ to █████ and █████. These resulted in tentative refunds of \$█████ in tax on █████ for █████ and \$█████ in tax on █████ for █████ (as well as \$█████ in interest for █████). The taxpayer has signed consents extending the period of limitations for the years the losses and credits arose. Adjustments of \$█████ were agreed to and assessed for █████. No adjustments have been made for █████.

In █████, following information received from the informant, the District Director determined that the taxpayer received excessive refunds of \$█████ for █████ and \$█████ for █████. The taxpayer disagrees with the Service's computations and also argues that collection of the erroneous refunds are barred by various statutes of limitation.

There are possibly three methods available to the Service to recover an erroneous refund: Suit under section 7405 of the Code; reinstitution of the taxpayer's liability followed by collection of the liability as if the tax had never been paid at all; and assessment and collection of the refund as a deficiency. The three methods are not mutually exclusive and can be used in the alternative. Thus, the availability of section 7405 as a remedy does not necessarily preclude use of one of the other procedures. S. Rep. No. 960, 70th Cong. 1st Sess. (1928), 1939-1 (Part 2) C.B. 409, 438; Milleg v. Commissioner, 19 T.C. 395 (1952). For an in-depth analysis of this issue, see G.C.M. 36263, Legality of Overpayment Offsets to Collect Unassessable Erroneous Refunds (No. 70-14) (5/9/75), as modified by G.C.M. 36624, Legality of Overpayment Offsets to Collect Unassessable Erroneous Refunds (No. 70-14) (3/11/76). We will analyze each of the possible avenues of recovery, their potential application to this case, and discuss the impact of developments after issuance of G.C.M.'s 36263 and 36624.

ERRONEOUS REFUND SUIT

Section 7405 of the Code authorizes the United States to bring a civil action to recover any portion of a tax erroneously refunded, whether erroneously refunded under section 6514 (refund made after expiration of period of limitations for filing claim or after expiration of period of limitation or filing suit) or otherwise.

Under section 6532(b) of the Code, the recovery of an erroneous refund by suit under section 7405 may be allowed only if the suit is begun within 2 years after the making of the refund, except that the suit may be brought within 5 years from the making of the refund if it appears that any part of the refund was induced by fraud or misrepresentation of a material fact.

It appears that the initial erroneous refunds of [REDACTED] were not due to any affirmative action by the taxpayer and were, instead, due to an error by the Service in recording the Court's judgment as a reduction in tax rather than a reduction in tax and abatement of interest. Therefore, there does not appear to be any fraud or misrepresentation on the part of the taxpayer in inducing the refund. Accordingly, we agree with your conclusion that the period of limitations for bringing suit against the taxpayer for either of the refunds made on that date has expired. You indicate that there are no grounds for application of the 5-year period of limitations to either refund. We agree, unless the Service can demonstrate that the [REDACTED] refund was induced by fraud or misrepresentation of a material fact. The question of whether there was such fraud or misrepresentation is inherently a factual one for you, the District Director's office, and the United States attorney to resolve.

REINSTATEMENT OF ORIGINAL LIABILITY

G.C.M. 36263 concludes that a "non-rebate" erroneous refund of a tax previously paid may be recovered by the usual assessment and collection procedures, including offset under section 6402 of the Code.¹ The rationale of G.C.M. 36263 is that the making of a non-rebate erroneous refund has the effect of reinstituting the taxpayer's liability for the amount of tax refunded so the Service can recover the refund through the same procedures, including offset, as it could have used to collect the tax had it never been paid at all. G.C.M. 36624 modifies G.C.M. 36243 and concludes that if the tax liability stated by a taxpayer on the

¹ Whether the refund in this case is a "rebate" is discussed in detail below.

return has been assessed by the Service under section 6201(a)(1), it is unnecessary to reassess the non-rebate erroneous refund if, and to the extent, the Service has assessed the tax for the tax year to which the refund relates. Because this theory relies on collection using the original assessment, it can only be used to collect amounts up to the amount of that assessment. Thus, if a taxpayer files a return showing no tax liability and withholding credits of \$100, but the Service erroneously credits the taxpayer with credit of \$1000 and refunds \$1000 instead of \$100, the erroneous \$900 refund cannot be collected administratively but must be recovered by suit under section 7405.

Under both G.C.M.'s, if the refund can be recovered through administrative collection procedures, the period of limitation provided by section 6502(a)(1) of the Code applies, beginning from the time the assessment was made with respect to the return filed by the taxpayer. If collection of the liability would be untimely under section 6502(a)(1), the refund may only be recovered through section 7405 (except by the common-law right of offset). In this case, the initial tax in question was assessed in [REDACTED] and [REDACTED], respectively, and the deficiencies in [REDACTED]. Under section 6502(a)(1), the period of limitations would have expired in [REDACTED] and [REDACTED], respectively, for the original assessments, and in [REDACTED] for the deficiency assessments.² Accordingly, this liability cannot be collected by reinstatement of the original liability.³

² The Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, section 11317, 101st Cong., 2d Sess. 1158 (1990) extended the period of limitations for collection under section 6502(a)(1) from 6 years to 10 years. The amendment is effective, however, only to those cases in which the 6-year period of limitations was open on November 5, 1990, the date of enactment of the change. Accordingly, the amendment of section 6502 does not affect the result here.

³ In any case, the reinstatement theory advanced in the G.C.M.'s is of questionable vitality today, particularly in cases in which taxpayers pay deficiencies and the Service refunds the payment. Several courts have rejected the Service's attempts to reinstate liabilities in such situations. For example, in United States v. Young, Civil Action No. 76-190 (D. Del. (1979) 79-2 USTC par. 9609, the court held that "the issuance of an erroneous refund by the Treasury Department cannot revive a deficiency assessment which has already been satisfied." See also Rodriguez v. United States, 629 F. Supp. 333 (N.D. Ill. 1986). (b)(7)a, (b)(7)e

[REDACTED]

DEFICIENCY PROCEDURES

Section 6201 of the Code provides different methods of assessing tax owed by taxpayers. These include assessment of tax shown on the return under section 6201(a)(1); assessment of erroneous income tax prepayment credits under section 6201(a)(3); and procedures for assessment of deficiencies of income, estate, gift, and certain excise tax contained in subchapter B of Chapter 63 of the Code (sections 6211--6216) under section 6201(d).

Section 6211(a) of the Code defines the term "deficiency" as follows:

For purposes of this title in the case of income, estate and gift taxes imposed by subtitles A and B, and excise taxes imposed by chapters 42 and 43, the term "deficiency" means the amount by which the tax imposed by subtitle A or B or chapter 42 or 43 exceeds the excess of--

(1) the sum of

(A) the amount shown as the tax by the taxpayer upon his return, if a return was made by the taxpayer and an amount was shown as the tax by the taxpayer thereon, plus,

(B) the amounts previously assessed (or collected without assessment) as a deficiency, over--

(2) the amount of rebates, as defined in subsection (b)(2), made.

Section 6211(b)(2) defines the term "rebate" as:

So much of an abatement, credit or refund, or other repayment, as was made on the ground that the tax imposed by subtitle A or B or chapter 42 or 43 was less than the excess of the amount specified in subsection (a)(1) over the rebates previously made.

Section 6501(a) of the Code provides the general rule that tax must be assessed within 3 years after the return is filed.

Section 6501(h) of the Code sets forth an exception to the general rule by providing that deficiencies attributable to the application of a net operating loss carryback may be assessed at any time before the expiration of the period of limitations for assessment of tax for the loss year.

Section 6501(j) of the Code also sets forth an exception to the general rule by providing that deficiencies attributable to the application of certain credit carrybacks may be assessed at any time before the expiration of the period of limitations for assessment of tax for the year the credit arose.

Section 6501(k) of the Code provides that:

In a case where an amount has been applied, credited, or refunded under section 6411 (relating to tentative carryback and refund adjustments) by reason of a net operating loss carryback, a capital loss carryback, or a credit carryback, (as defined in section 6511(d)(4)(C)) to a prior taxable year, the period described in subsection (a) of this section for assessing a deficiency for such prior taxable year shall be extended to include the period described in subsection (h) or (j), whichever is applicable; except that the amount which may be assessed solely by reason of this subsection shall not exceed the amount so applied, credited, or refunded under section 6411, reduced by any amount which may be assessed solely by reason of subsection (h) or (j), as the case may be.

Section 6213(b)(3) of the Code provides that:

If the Secretary determines that the amount applied, credited, or refunded under section 6411 is in excess of the overassessment attributable to the carryback or the amount described in section 1341(b)(1) with respect to which such amount was applied, credited, or refunded, he may assess without regard to the provisions of paragraph (2) the amount of the excess as a deficiency as if it were due to a mathematical or clerical error appearing on the return.

Section 6213(b)(1) of the Code authorizes the Service to assess mathematical and clerical errors. Although notice to the taxpayer is required, the notice is not considered to be a notice of deficiency.

Reduced to a mathematical equation, a deficiency = correct tax - (tax on return + prior assessments - rebates) or = correct tax - prior assessments + rebates. Kurtzen v. Commissioner, 17 T.C. 1542 (1952). Thus, there is a distinction between situations in which a refund is made to the taxpayer because of a "rebate" and those in which the refund was made for other reasons. In a rebate case, the Service must assess the tax as a

deficiency.⁴ On the other hand, if the refund was not a "rebate", the deficiency procedures under subchapter B of Chapter 63 of the Code are inapplicable mathematically. In such situations, the Service may collect the tax by reinstituting the liability, as described above, or may bring suit under section 7405. In this case, if the [REDACTED] refunds were not rebates, there can be no deficiency definitionally. Accordingly, it is important to determine whether the erroneous refund is a "rebate erroneous refund" or a "non-rebate erroneous refund."

We believe it is debatable whether the erroneous refund here was due to a rebate or was a miscomputation by the Service in the amount of interest due the taxpayer. Such miscomputations have generally been held not to be rebates that enter into the mathematical computation of the deficiency.

In Levy v. Commissioner, 18 B.T.A. 337 (1929), acq. IX-2 C.B. 35, aff'd 48 F. 2d 725 (9th Cir. 1931), the Board held that although an amount of tax paid that is erroneously refunded may be the subject of a deficiency, the interest paid out to the taxpayer on an erroneous refund is not the subject of a deficiency because it was not literally "repaid," as required by the predecessor of section 6211(b)(2) of the Code. G.C.M. 36623 relied on Levy in concluding that interest paid by the Government to the taxpayer on an erroneous refund may not be recovered through assessment.

In Groetzinger v. Commissioner, 69 T.C. 309 (1977), the Tax Court considered a situation in which the Service made an erroneous refund to the taxpayer after the taxpayer paid a deficiency determined by the Service. The court held that the amount of the erroneous refund was not a rebate because it resulted from the Service erroneously believing that the taxpayer

⁴ The summary assessment procedure under section 6213(b)(3) provides a mechanism to restore the Service and the taxpayer to the same position occupied before approval of the application for the tentative carryback adjustment. See H.R. Rep. No. 849, 79th Cong. 1st Sess. 25 (1945), 1945 C.B. 566, 583; Rev. Rul. 88-88, 1988-2 C.B. 354. This does not mean, however, that the amount assessable under section 6213(b)(3) does not have to fit within the mathematical definition of "deficiency" under section 6211. Compare this to assessment of erroneous prepayment credits outside the deficiency procedure under section 6201(a)(3), in which "amounts overstated" may be assessed without regard to whether or not they constitute deficiencies. Despite the summary nature of the procedure (no deficiency notice is required under section 6212), an assessment under section 6213(b)(3) is still an assessment of a deficiency under subpart B of Chapter 63 and as such must fit within the definition of a deficiency under section 6211.

had paid more than the tax. According to the court, the refund "was made for a reason other than that specified in section 6211(b)(2)" and did not result in a refund. Accordingly, the court found that there was no deficiency. (The Service won the case, however, on other grounds because the court found it had jurisdiction to impose transferee liability on the taxpayer's heirs).

Because it appears that the refund was due because of a miscalculation of interest due the taxpayer, we believe that it may have been a non-rebate refund, i.e., one made because of grounds other than the tax imposed by subtitle A was less than the excess of the tax shown on the return plus amounts previously assessed as a deficiency. If neither of the [redacted] refunds to the taxpayer were "rebates" within the meaning of section 6211(b)(2) of the Code, the amount owed by the taxpayer is not a "deficiency" within the meaning of section 6211(a). Thus, the tax could not be assessed through the deficiency procedures.

On the other hand, it could be argued that the amount in question is a rebate because the refund was made on the grounds that the tax should be been reduced by \$ [redacted] rather than \$ [redacted], thus leaving the [redacted] dollar difference as a rebate.⁵

The District Director suggests that section 6501(k) of the Code extends the 3-year period of limitations for [redacted] and [redacted] for the period of time for which the tax for the loss year may be assessed up to the amount that was refunded or credited under section 6411. Thus, the Service can arguably timely mail a notice of deficiency. Because no Tax Court petition was filed, the second notice prohibitions of section 6212(c) do not apply. Unlike taxes assessable under section 6501(h), assessments made under this provision need not be attributable to the carryback but are, instead, limited to the amounts applied, credited, or refunded under section 6411.

We reject this argument for several reasons. First, section 6213(b)(93) of the Code would seem to preclude recovery of the refund under subpart B of chapter 63. Under section 6213(b)(3), an excessive tentative carryback of a net operating loss or credit carryback can be recovered as a deficiency (albeit without regard to the notice provisions of section 6212) only if the Service determines that "the amount applied, credited, or refunded under section 6411 is in excess of the overassessment

⁵ No such argument could be made for amounts that exceed the difference between the reduction in tax and the amount of reduction found by the Claims Court. Any additional amounts refunded are clearly additional interest and are excluded from the computation of the deficiency under Levy.

attributable to the carryback...with respect to which such amount was applied, credited, or refunded." In this case, the amounts refunded in [REDACTED] and [REDACTED] under section 6411 were not in excess of the overassessment attributable to the carryback. There was no time at which the tentative refunds ever were incorrect, either because of the amount of the carryback themselves or because of other items that could have been disallowed in order to offset an otherwise valid carryback. Second, as we indicated above, the erroneous refunds may not have been "rebate" erroneous refunds that gives rise to liabilities assessable under deficiency procedures. Finally, even if the amount owed is a deficiency, we believe that the principles of res judicata bar the Service from reinstituting the liability in any form other than under section 7405.

Under res judicata a final judgment or decree on the merits by a court of competent jurisdiction is conclusive of rights of parties in all later suits on points and matters determined in the former suit. Black's Law Dictionary 1470 (4th ed. 1968). As applied to federal tax law, once a court of competent jurisdiction enters a final judgment on the merits as to the tax liability of a taxpayer for a specific year in question, the judgment is res judicata as to any subsequent proceeding involving the same claim and the same tax year. Commissioner v. Sunnen, 333 U.S. 591, 599 (1948), 1948-1 C.B. 7. The rule extends to situations that might have been brought up but were not. In Armco Steel Corp. v. United States, No. 8243 (S.D. Ohio W.D. (1974) 74-1 USTC par. 9428, the taxpayer was barred from claiming foreign tax credit after the taxpayer's original suit was dismissed with prejudice. The court noted that "the parties are bound as to every matter which was offered and received and any other matters which might have been offered in the same cause of action." Here, the Service could have raised other matters in defense of the taxpayer's refund suit in the Claims Court but did not. Accordingly, it is barred from raising those now. Similarly, in Milleg, the Tax Court found that while the Service could allow a claim for refund and at a later date reopen the case and redetermine the tax, it could only do so "in the absence of a closing agreement, valid compromise, final adjudication or the running of the statute of limitations." 19 T.C. at 398. Thus, the existence of a final adjudication precludes the Service from making another assessment.

If the order of refunds were different (i.e., if the tentative refund under section 6411 of the Code were made after the erroneous refund), res judicata would arguably not apply. In such a case, we would recommend summary assessment under section 6213(b)(3) because there is sufficient doubt whether the Tax Court would agree there is a deficiency under section 6211 in light of Groetzinger. We believe there would be a better chance of prevailing in such a situation in refund litigation.

Finally, we considered the applicability of action under the False Claims Act, 31 U.S.C. 3729 (1988) as a mechanism to recover the refund. G.C.M. 38128, Recovery of Erroneous Refunds - Control No. 75 12 04 2149 (10/1/79) stated that in a case in which a taxpayer receives an inordinately large refund check and cashes the check knowing that he/she is not due the amount of the check, the taxpayer could be liable for damages under the False Claims Act. Since G.C.M. 38128 was issued, the False Claims Act was amended to specifically exclude "claims, records, or statements made under the Internal Revenue Code" from its purview. Accordingly, G.C.M. 38128 is obsolete and the option suggested therein is inapplicable.

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